

How to Classify Your Workers as Statutory Employees

By Andrew G. Poulos, EA, ABA, ATP

We have been hearing lately that worker classification issues are on the forefront for the IRS and state labor agencies. Because big companies and small businesses are misclassifying workers, this subject has become one of the hottest matters in our industry.

Oftentimes, you may think that the misclassification is for the independent contractor vs. employee category. However, that is not always the case because there are four worker classification categories that can be misclassified: **independent contractors, common-law employees, statutory employees and non-statutory employees**. The classification decision should not be based upon what the employer and worker decide, or any agreement they may create. Instead, the decision should be based on the type of services the worker will perform for the employer and whether the employer's actions dictate "control" over the worker. Depending on the facts and circumstances, control is an issue in itself that can be argued various ways.

Once the control factor is determined, it becomes a bit easier to classify a worker in one of the four categories. The most common categories are independent contractor and common-law employee. Because these two categories are well known, let's address the one that often gets misclassified. A classification mistake can be costly for the business and even more so for the worker. Although statutory employees are not as common, it can be just as costly if misclassified.

To be a statutory employee, a worker must fall into one of the four categories and must meet the three conditions under Social Security and Medicare tax laws. The four categories for statutory employees are as follows:

1. Driver who distributes beverages (no milk), meat, vegetables, fruit or bakery products, or picks up and delivers laundry or dry cleaning (paid on commission or is an agent).
2. A full-time life insurance sales agent. The principal business activity must be selling life insurance or annuity contracts (or both) primarily for "one" life insurance company.
3. An individual who works at home (homeworker) on materials or goods that the business supplies and that must be returned to the business or to a person the business names. There should be instructions furnished for the work that needs to be done.

4. A full-time traveling or city salesperson who works on behalf of the business and turns in orders from wholesalers, retailers, contractors, hotel operators, restaurants or similar businesses. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation.

It should be noted that the work performed by the salesperson on behalf of the employer should be the salesperson's "principal" business activity.

Once the worker is classified in one of the four statutory employee categories, then the FICA laws must be met. The employer must withhold Social Security and Medicare taxes from a statutory employee's wages if all three of these conditions apply:

1. The service contract states or implies that "substantially" all the services are to be performed "personally" by the employee.
2. The employee does not have a substantial investment in equipment or property used to perform the services (other than transportation such as a vehicle).
3. The services are performed on a continuing basis for the same employer.

Successfully classifying a worker as a statutory employee can be advantageous to the worker. The employer is required to withhold FICA taxes from the statutory employee's wages, but does not have to withhold federal income tax. The employer should furnish a W-2 to the statutory employee with Box 13 "Statutory Employee" checked. Following proper procedure allows the statutory employee to claim business expenses on "Schedule C" as if he or she is an independent contractor. However, unlike an independent contractor, the person does not have to pay the full 15.3 percent of FICA tax because the business is responsible for paying the employer portion. Currently, the 2012 FICA tax rate for employees is 5.65 percent, which gives a statutory employee a significant savings versus being misclassified as an independent contractor and being responsible for 15.3 percent FICA taxes.

Misclassification can be damaging to the employer and the worker, but with statutory employee cases, the employee often times tends to lose out more than the employer because they may be stuck with paying 15.3 percent FICA taxes when, in fact, the employee should not be responsible to pay the entire amount. In other situations where the employer misclassifies the employee as a common-law employee instead of a statutory employee, the employee is at a disadvantage because the person does not get to file a Schedule C and claim business

expenses. In this type of misclassification, the employee must report his or her business expenses on Schedule A as unreimbursed employee expenses subject to the 2 percent threshold, assuming the employee has enough deductions to even file a Schedule A.

You can see that what *appears* to be a simple misclassification can become a major loss to the worker. Of course, the employment tax liability and statutory fines the business can face are equally important.

Case Example

Let's look at an example where Steve, a full-time life insurance agent who works only for one insurance company, gets misclassified as an independent contractor. In 2011, the employer paid Steve \$88,000 and issued him a 1099-MISC when, in fact, he should have received a W-2 with Box 13 "Statutory Employee" checked. Steve worked from home incurring \$1,500 for a business telephone line, \$250 for office supplies, \$850 for advertising, \$680 in meals and entertainment which qualify as a business expense, and drove 26,800 business miles for the year (13,400 miles driven January 1 – June 30 at \$0.51 per mile, and 13,400 miles driven July 1 - December 31 at \$0.555 per mile).

As a statutory employee, Steve would file a Schedule C and claim \$2,940 of deductible expenses and \$14,271 for standard mileage expense, giving him total expenses of \$17,211 to deduct against his earnings of \$88,000. His net income taxable for FICA is \$88,000, which gives him a FICA tax liability of \$4,972 ($\$88,000 \times 5.65$ percent) and his net taxable income for federal taxes is \$70,789.

Since Steve was *misclassified* as an independent contractor and issued a 1099-MISC, he will file a Schedule C where he would be able to deduct the same expenses against his income. In this case, however, Steve's FICA tax liability will be \$8,695 ($\$70,789 \times 13.3$ percent). By being misclassified, Steve incurs an additional FICA tax liability of \$3,723!

In this example, had Steve worked for two insurance companies, he would not qualify as a statutory employee because the law requires a full-time life insurance salesman to work full-time in the industry for only one insurance company. Rev. Rul. 59-103 provides guidance further guidance on this matter.

It is important that your clients understand the worker classification categories in order to make proper classification choices. It is even more important that you, the accounting professional, provide your client with the tools and knowledge needed to make the correct

decisions. You also have to be able to defend the position with reasonable basis should the IRS or a state labor agency place your client under audit.

About the Author

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